UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF PENNSYLVANIA

In re:	:	Chapter 7
J3 ENERGY GROUP, INC.,	:	Case No. 14-00532 (JJT)
Debtor	:	
APPLIED ENERGY PARTNERS, LLC,	:	
Movant	:	
vs.	:	
STEPHEN RUSSIAL,	:	
Respondent	:	

OBJECTION TO CLAIM NUMBERS 6 AND 7

Applied Energy Partners, LLC ("Objector") files this Objection to Claim Numbers 6 and 7 and, in support thereof, respectfully represents as follows:

BACKGROUND

1. Stephen Russial ("Russial") filed Proof of Claim numbers 6 and 7, essentially seeking reimbursement from the Debtor on an indemnification theory.

2. Russial seeks reimbursement for a purported "shareholder loan" but this transaction is completely undocumented and is properly characterized as a capital contribution for which Russial is not entitled to reimbursement.

3. Russial seeks indemnification for his personal liability on a state court judgment. But Russial's indemnification claim is a logical impossibility: (1) if the state court upholds his personal liability on rehearing, he is not entitled to indemnification under the Debtor's bylaws because the state court necessarily

{01411636;v1 }

would have found Russial committed malfeasance on his personal behalf and not as an officer of the Debtor; or (2) if the state court finds Russial was not personally liable, then there is no need for indemnification for the amount of the judgment.

4. Either way, Russial is not entitled to reimbursement for the judgment amount. Additionally, the Debtor is jointly liable on the same judgment. If the Debtor makes any payment on the judgment, it should make the payment directly to the judgment creditor, not to Russial.

5. The final portions of Russial's claims seek reimbursement for legal fees. The claimed legal fees, however, appear to have been incurred for Russial's personal benefit or relate to services provided to a non-debtor affiliate. Neither are reimbursable.

6. Finally, the Debtor has significant counterclaims against Russial. During the last few months of his ownership, upon information and belief, Russial ordered the Debtor's employees to significantly curtail the services they provided to the Debtor's customers. This purposeful slowdown has resulted in customers refusing to pay over $100,000 in earned commissions and lost revenue of approximately $400,000 per year from customers who refused to continue doing business with the Debtor.

7. Russial also caused the Debtor to overcompensate Russial and his wife for tax reimbursements and caused the Debtor to pay certain pre-petition tax obligations of Russial and his wife out of post-petition funds without Court approval. These overpayments/unauthorized payments total over $21,000.

OBJECTION TO CLAIM NUMBER 6

8. Claim Number 6 is comprised of three parts: (i) a purported shareholder loan in the amount of $49,250.00; (ii) reimbursement for a judgment in the amount of $343,887.00; and (iii) reimbursement for pre-petition attorney's fees in the amount of $1,045.00.

9. None of these claims has any validity.

A. The Purported Shareholder Loan

10. Russial seeks reimbursement for a purported "shareholder loan" as documented by line items on excerpts from the Debtor's tax returns from 2008 through 2013. The "shareholder loan", however: (i) is completely undocumented; (ii) was never previously disclosed to this Court by Russial in the Debtor's schedules or Russial's proposed reorganization plan and related disclosure statements; and (iii) is no longer Russial's claim to assert because he is no longer the shareholder.

11. Further, the distributions Russial received from the Debtor after the purported "loan" greatly exceed the amount of the "loan."

12. The purported "Loan" is Actually a Capital Contribution.

13. No business records exist to document this purported "loan." There is no loan agreement in the Debtor's business records. There is no note in the Debtor's business records setting forth the repayment terms. The Debtor has no way of knowing when or how this "loan" was to be repaid and Claim Number 6 provides none of that documentation.

{01411636;v1 }

14. Claim Number 6 falls far short of documenting the existence of the purported "loan" and does not establish that Russial has any immediate right to payment.

15. Courts have found that such completely undocumented "loans" are not loans at all and should be characterized as capital contributions. In Maines Paper & Food Serv. V. Hoffman Restaurant Group, Inc., 2013 Pa. Dist & Cty Dec. LEXIS 57, the court held:

> The alleged shareholder loans claimed by the Hoffmans were neither well documented or "arms length" transactions. They were in the nature of "secret" debts kept unknown to other creditors to be used at the whim of the Hoffmans to defeat the claims of creditors. There is a lack of formal documentation of the loans, there is no evidence of the of the terms of the alleged loans and no proof of any payment of any interest on these alleged loans. The lack of such evidence severely militates against any finding that the infusion of money was a loan.
>
> Therefore, I find that the purported loans advanced by the defendant were not legitimate shareholder loans but merely infusions of capital.

Maines Paper at *7. A copy of the Maines Paper decision is attached as Exhibit A.

16. Russial's purported "shareholder loan" is exactly the type of secret debt that the Maines Paper court found troubling. In addition to being completely undocumented, Russial failed to disclose the existence of the purported "loan" on the Debtor's schedules that he signed under penalty of perjury. The purported loan was not mentioned in any of the various disclosure statements Russial filed in this case. The plan of reorganization proposed by Russial did not list the purported "loan" and did not provide for any repayment.

17. Mirroring the language of the Maines Paper court, Russial's purported "loan" was in the nature of a "secret" debt kept unknown to other

creditors to be used at the whim of Russial to defeat plan confirmation or the claims of creditors.

18. The fact that Russial labels the capital contribution as a "loan" is equally unavailing. As the Third Circuit has stated:

> In a corporation which has numerous shareholders with varying interests, the arm's length relationship between the corporation and a shareholder who supplies funds to it inevitably results in a transaction whose form mirrors its substance. Where the corporation is closely held, however, and the same persons occupy both sides of the bargaining table, form does not necessarily correspond to the intrinsic economic nature of the transaction, for the parties may mold it at their will with no countervailing pull. This is particularly so where a shareholder can have the funds he advances to a corporation treated as corporate obligations instead of contributions to capital without affecting his proportionate equity interest. Labels, which are perhaps the best expression of the subjective intention of parties to a transaction, thus lose their meaningfulness.
>
> Fin Hay Realty Co. v. U.S., 398 F.2d 694, 697 (3d Cir. 1968).

19. Russial was the only shareholder of the Debtor when the capital contribution was made. In other words, he occupied both sides of the bargaining table in the transaction. The fact that Russial calls the capital contribution a "loan" is meaningless when there are no other objective indicia of the existence of a loan, such as a loan agreement or note.

20. The contribution, if any, was a capital contribution, not a "loan." Russial, therefore, has no right to recover this amount as an unsecured creditor.

21. Even if this Court Determines a Shareholder Loan Existed (which it should not), Russial is not entitled to any reimbursement.

22. In the alternative, to the extent this Court determines a "loan" ever existed (which this Court should not), the Debtor's business records and its

bankruptcy filings indicate that the Debtor's subsequent disbursements to Russial vastly exceed the amount of the purported "loan."

23. The purported "loan" dates back to before 2008. The Debtor's transaction register indicates that Russial and his wife received $398,000 in distributions from the Debtor's profits during 2012. It would have been a breach of Russial's fiduciary duties to the Debtor to make such enormous distributions to himself and his wife without paying off the purported "loan" to the Debtor.

24. Even if such "shareholder loan" exists and remains unpaid, Russial cannot claim reimbursement for such loan. Russial is no longer a shareholder of the Debtor. His shares were purchased by Christopher Gutteridge at a sheriff's auction. Any purported rights under a "shareholder loan" would have passed to Mr. Gutteridge when he purchased all of the outstanding shares of the Debtor.

25. A shareholder loan constitutes in part of the shareholder's tax basis in the company, but it is not the only part. The shareholder's tax basis will also include items such as capital stock and retained earnings. Since the entire shareholder tax basis passed from Russial to Gutteridge at the time of the sale, the "shareholder loan" cannot be viewed in isolation. The purported "shareholder loan" is one component part of the rights that Mr. Gutteridge acquired as the shareholder. If any party has a right to assert a claim for the purported "shareholder loan," it is Gutteridge, not Russial.

B. Reimbursement for Judgment Liability

26. Russial seeks indemnification for liability on a personal judgment in the amount of $343,887.00. Russial's claim, however, is a logical impossibility:

27. If the State Court upholds Russial's personal liability on the judgment, Russial is not entitled to indemnification under the Debtor's bylaws (as explained below) because the State Court will have found Russial was sufficiently acting in his personal capacity;

28. If the State Court finds that Russial is not personally liable, then indemnification for the amount of the judgment is not necessary because Russial will no longer be personally liable.

29. In other words, there is no potential circumstance where the Debtor would be required to indemnify Russial for the amount of the judgment.

30. Russial is not entitled indemnification for actions taken in his personal capacity. The Chester County Court of Common Pleas ("Trial Court") found Russial personally liable on the judgment because Russial was acting on his own behalf during events that gave rise to the judgment.

31. Russial is not entitled to indemnification from the Debtor for actions taken in his personal capacity. The Debtor's bylaws limit the indemnification to actions taken while "serving in an indemnified capacity." Section 7.01(d)(1) of the Bylaws defines "indemnified capacity" in pertinent part as:

> Any and all past, present and future service by an indemnified representative in one or more capacities as a director, officer, employee or agent of the corporation.

A copy of the Debtor's Bylaws is attached to Claim Number 6.

32. Actions taken by Russial on his personal behalf are not entitled to indemnification because such actions cannot fit within the definition of "indemnified capacity" under the Bylaws. The term "indemnified capacity" only covers actions taken in one or more capacities as a director, officer, employee or agent of the Debtor. The term does not cover actions taken on an individual's personal behalf.

33. The Trial Court already litigated this issue and found Russial was sufficiently acting on his own behalf to justify entry of a personal judgment against him.

34. The issue of Russial's personal liability, however, was subject to an appeal and is set for reargument. If Russial prevails at reargument, his personal liability disappears and there is no need for indemnification because Russial would no longer have personal liability. If the personal judgment stands, Russial is not entitled to indemnification because the Trial Court's finding regarding Russial's actions taken in his individual capacity will have been upheld.

35. Either way, Russial has no right to indemnification for the amount of the judgment.

36. Additionally, Russial has not paid any money as a result of the state court judgment, so he is not entitled to reimbursement at this time. The Debtor is also jointly liable under the same judgment. To the extent the Debtor is required to pay money with respect to the judgment (either on behalf of itself or on behalf of Russial), it should pay such money directly to the judgment creditor, not to Russial.

C. **Reimbursement for Legal Fees**

37. The final portion of Claim Number 6 seeks reimbursement for pre-petition attorney's fees billed by Joseph Zerbe ("Zerbe"). Zerbe was retained as a professional in this case as special counsel to both the Debtor and to Russial personally in the state court appeal.

38. Applied Energy Partners ("AEP") filed a limited objection to Zerbe's fee application because AEP felt it was unfair and inappropriate to have the Debtor pay for the portion of Zerbe's fees attributable to work done for Russial personally.

39. Russial did not assert any right to indemnification during the approval process for Zerbe's fees. Nor is Russial entitled to indemnification based on the preceding section. Rather, Zerbe agreed to bifurcate his billing between the portion attributable to the Debtor and the portion attributable to Russial personally.

40. This Court entered an order approving the bifurcated fees. The Debtor has paid Zerbe approximately $10,000, which represents payment in full for the Debtor's share of Zerbe's bifurcated fees.

41. Zerbe basically split his fees in half, attributing work equally between the Debtor and Russial. In reality, the lion's share of Zerbe's work was directed at eliminating Russial's personal liability on the state court judgment. This work not only benefitted Russial, it also ran contrary to the Debtor's interests. If Russial's personal liability is eliminated, then the Debtor is solely

liable for the entire judgment. It would obviously be better for the Debtor if there were another party also liable on the judgment.

42. The focus of Zerbe's work becomes clearer upon a closer examination of the legal invoice attached to Claim Number 6. There are 36 time entries on the invoice. Each entry is split equally between the Debtor and Zerbe. Of the 36 entries, 33 of them reference an email to or from Russial.

43. None of these emails, however, appears in the Debtor's business records. Russial has previously certified under penalty of perjury that he returned all of his business emails to the Debtor via compact disc on April 23, 2015. None of the emails referenced in Zerbe's invoice was on the compact disc. A copy of Russial's certification is attached as Exhibit B.

44. The Debtor should not be compelled to reimburse Russial for legal services that solely benefitted Russial personally.

45. To the contrary, Russial should reimburse the Debtor for any portion of these fees that were already paid by the Debtor. The Debtor apparently did not benefit from this work, so the Debtor should not have paid for it. Russial appears to be the only party who benefitted from this work, so he should pay for it from his own funds.

OBJECTION TO CLAIM NUMBER 7

46. Claim Number 7 seeks administrative expense treatment for post-petition legal fees incurred by Russial for three professionals: (i) Zerbe, (ii) Cerullo Datte & Burke, and (iii) Brian Manning. The Debtor reiterates its general objection to Claim Number 7 on the basis that Russial is not entitled to

indemnification, as set forth above. This objection will address the claims related to these professionals individually.

A. Zerbe Fees

47. As stated above, this Court approved Zerbe's employment as special counsel to the Debtor while also representing Russial personally. AEP objected to the Debtor paying Zerbe's fees in full based on the dual representation. Zerbe agreed to bifurcate his fees between work done for the Debtor and work done for Russial. Zerbe essentially split his fees equally between the Debtor and Russial. As stated above, an equal split does not appear appropriate.

48. Russial did not assert a right to indemnification at any time during Zerbe's retention process.

49. The first three pages of Zerbe's invoice are duplicative of the fees sought by Russial in Claim Number 6. Russial offers no justification why these pre-petition fees should be accorded post-petition administrative expense priority. The duplicative pre-petition fees should be stricken from Claim Number 7 and dealt with per the Debtor's objections to Claim Number 6.

50. Of the 153 remaining entries, 117 of them involve at least one email to/from Russial.

51. None of these emails, however, appears in the Debtor's business records. Russial has previously certified under penalty of perjury that he returned all of his business emails to the Debtor via compact disc on April 23, 2015. None of the emails referenced in Zerbe's invoice were on the compact disc.

52. The Debtor should not be compelled to reimburse Russial for legal services that solely benefitted Russial personally.

53. In fact, Russial should reimburse the Debtor for any portion of these fees that were already paid by the Debtor. The Debtor apparently did not benefit from this work, so the Debtor should not have paid for it. Russial appears to be the only party who benefitted from this work, so he should pay for it from his own funds.

54. In addition, Russial seeks reimbursement for 12.75 hours of Zerbe's time to attend hearings in the Bankruptcy Court. Zerbe was retained as special counsel solely to prosecute the appeal pending in Superior Court. At all relevant times, Kevin Kercher was the Court-approved counsel to the Debtor. Zerbe was never called as a witness and it is unclear what, if any, role Zerbe played in such hearings or why his presence was necessary. The Debtor apparently did not derive any benefit from Zerbe's presence in Bankruptcy Court and his attendance was beyond the scope of his Court-approved retention.

55. If Zerbe attended Bankruptcy Court at the behest of Russial, Russial should pay for Zerbe's time out of his own funds. Additionally, the Debtor should recover from Russial any attorney's fees the Debtor paid for Zerbe to attend Bankruptcy Court hearings.

B. Cerullo Datte & Burke Fees

56. As a threshold matter, pages 24 and 25 of Claim Number 7 appear to be duplicates. The calculation of Claim Number 7 should be adjusted as necessary to avoid any double recoveries.

57. Additionally, Cerullo Datte & Burke, P.C. ("Cerullo Firm") was never retained as a professional in this case. It is unclear upon what basis this Court can grant administrative priority to the fees of such a professional.

58. Russial, however, should not be permitted to recover any fees of the Cerullo Firm in any event. The Cerullo Firm represented J3 Energy Services, Inc. ("Services") in a discovery matter and then later represented Russial related to the Debtor's efforts to recover business records from Russial.

59. The Cerullo Firm assisted non-debtor entity J3 Energy Services, Inc. ("Services") in responding to discovery requests served by AEP in aid of execution on the State Court judgment. Services, therefore, was the client and Russial has no standing to assert a claim on behalf of Services.

60. Russial testified at the meeting of creditors in this case that he formed Services solely to effectuate a name change of the Debtor and that Services engaged in no business whatsoever. If that is true, there would be no reason to engage an additional professional to represent Services when Zerbe was already retained to represent the Debtor in the same matter.

61. While Zerbe's representation was disclosed and approved by this Court, the Cerullo Firm's representation was not. In addition, Russial failed to assert his indemnification claim for about a year and a half. The net result is that Russial caused the Debtor to incur sub rosa purported administrative expense claims that never appeared on the Debtor's monthly operating reports. This Court should not effectively grant Russial nunc pro tunc approval for professional fees that were never approved by this Court.

62. Tellingly, Services does not appear as the client on the Cerullo Firm's invoices for that period. Russial is the client. As stated above, Russial is not entitled to indemnification under the Debtor's bylaws for his personal expenses related to the State Court judgment.

63. If Services was the Cerullo Firm's client, then Russial has no standing to assert those claims against the Debtor. Russial no longer owns Services and is no longer an officer of that entity. Collection of the Cerullo Firm's fees is a matter between the Cerullo Firm and Services.

64. The second portion of the Cerullo Firm's fees are related to the Debtor's efforts to recover business records from Russial. Russial is not entitled to any indemnification for his actions taken in this case after the change in ownership. Russial was no longer a shareholder and he is asserting positions based on his personal interest and not in any capacity related to his status as a shareholder/officer or former shareholder/officer of the Debtor.

65. Further, Russial is not entitled to indemnification for legal fees incurred on his personal behalf that are directly adverse to the Debtor. Russial may be entitled to indemnification for actions taken on behalf of the Debtor but he is not entitled to any actions taken that are directly adverse to the Debtor under the Bylaws. Russial's claim for these fees does not fit within the letter or the purpose of the indemnification provision in the Bylaws.

COUNTERCLAIMS AGAINST MR. RUSSIAL

66. The Debtor has significant counterclaims against Russial and his wife that more than offset potential liability, if any, that the Debtor has to Russial under Claims 6 and 7. The counterclaims are summarized as follows:

67. Overcompensation of Russial: Russial drew a salary from the Debtor during this case while he was the owner and was retained by the Chapter 7 Trustee to manage the Debtor's day-to-day operations. Upon information and belief, however, Russial directed the Debtor's employees to not service customer accounts at normal levels or invoice customers. Upon information and belief, this process started in the months prior to conversion to Chapter 7 and continued while Russial was a retained professional during the Chapter 7 portion of this case. Since Russial was not doing the job he was being paid to do, the Debtor is entitled to recover any compensation he received during that time. The Chapter 7 Trustee has declined to pursue such a recovery against Russial, but the Objector reserves the right to assert such liability.

68. Damages to J3: Since the Debtor apparently was not regularly servicing or invoicing its customers for months at Russial's direction, the Debtor was unable to collect all of the commissions owing to the Debtor or negotiate renewals with customers that felt they had been ignored once the Debtor reinitiated contact with the customers under new management. The Debtor's lost revenue from unpaid commissions totals $101,645.84. The Debtor's lost revenue from customers that refused to renew is approximately $400,000 per year.

69. Excessive Tax Reimbursement. The Debtor made several distributions to Russial and his wife for tax reimbursements. The Debtor listed

{01411636;v1 }

these reimbursements on its operating reports. The amount of the tax reimbursements, however, vastly exceeded Russial's tax liability based on the Debtor's revenue during the same period. The Debtor's records indicate Russial and his wife received $20,000.00 in tax reimbursement distributions for 2014 taxes. Based on the Debtor's revenue during the relevant period, however, the Russials' tax reimbursement should have been no more than $10,513. The Debtor overcompensated Russial and his wife $9,487.00 for 2014 taxes.

70. Unauthorized Post-Petition Distributions. On May 13, 2014 and July 15, 2014, Russial made distributions to himself and his wife totaling $12,500.00. Russial made these distributions during this bankruptcy case while he was still the Debtor's sole shareholder. Russial made these distributions to satisfy certain pre-petition tax obligations of himself and his wife. Russial had no bankruptcy court authorization to pay these pre-petition obligations out of post-petition funds.

71. The Chapter 7 Trustee has declined to initiate litigation against Russial and his wife, as necessary, to recover the amounts of the excessive compensation, damages, excessive reimbursement and unauthorized post-petition transfers. The Objector asserts that those claims against Russial are an offset any potential liability the Debtor may have to Russial under Claims 6 and 7.

RESERVATION OF RIGHTS

72. The Objector's investigation of Claims 6 and 7 remains on-going. The Objector reserves the right to supplement this Objection as additional information becomes available through discovery and otherwise.

73. The Objector also reserves the right to brief and supplement the legal arguments contained in this Objection as the Objector deems appropriate under the facts and circumstances of this case.

WHEREFORE, for the foregoing reasons, the Objector respectfully requests that this Court enter an Order: (a) disallowing Claim Number 6 with prejudice, (b) disallowing Claim Number 7 with prejudice, and (c) granting such other relief as this Court deems equitable.

Dated: February 10, 2017

Respectfully submitted,

Hartman, Valeriano, Magovern & Lutz, PC

by: */s/ George M. Lutz*

George M. Lutz, Esquire
1100 Berkshire Boulevard, Suite 301
Wyomissing, PA 19610
Pa. Attorney ID No.: 46437